The City of London Law Society

The Law Society

TRANSPOSITION OF THE BANK RECOVERY AND RESOLUTION DIRECTIVE

1. INTRODUCTION

1.1 This paper is submitted by the Financial Law Committee and the Insolvency Law Committee of the City of London Law Society and the Banking Reform Working Group of the Law Society of England and Wales (the "Committees"), in response to the Consultation Paper published in July 2014.

1.2 The City of London Law Society (CLLS) represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government Departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees.

1.3 The Law Society of England and Wales is the representative body of over 159,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representation to regulators and Government in both the domestic and European arena.

1.4 The Committees submitting this paper are made up of solicitors specialising in UK and international financial and insolvency law in a number of law firms based in the City of London, who advise and act for UK and international financial institutions and businesses and for regulatory and governmental bodies on financial and insolvency law matters.

1.5 This paper addresses the questions raised in the Consultation Paper, so far as in areas within the remit of the Committees.

2. REMOVING IMPEDIMENTS TO RESOLVABILITY

2.1 *(1) Do you agree that the powers to remove impediments to resolvability should only extend to mixed-activity holding companies where its subsidiary institutions are not held directly or indirectly by an intermediate holding company, with the exception of the power to require a mixed-activity holding company to establish an intermediate holding company.*

We agree with this approach. We consider it important if mixed-activity groups, such as major retailers, are to be encouraged to provide competition in banking and financial services, which we believe is in the interests of consumers.

2.2 *(2) Do you agree with the proposal to model the right of appeal on s. 55Y of FSMA?*

Yes.

2.3 (3) *Should the Bank of England be given a direct enforcement power in relation to resolution?*

Provided that the PRA has a full set of enforcement powers in relation to resolution, we are not clear why the Bank also needs such powers. It is confusing if more than one authority had concurrent powers and we suggest that if the Bank of England is given powers in this area, it is essential that rules are put in place to ensure that there can be no confusion and that there is a hierarchy that makes it clear which authority should exercise any particular power in any particular circumstances.

2.4 (4) *Do you have any comments on the features of that enforcement power? Do you agree it should be modeled on the current enforcement powers of the PRA, FCA and Bank under FSMA?*

See answer at 2.3 above. If the Bank of England is given separate enforcement powers they should follow the same format as those of other authorities and a hierarchy for the application of duplicated powers will need to be put in place.

3. EARLY INTERVENTION

3.1 (5) *Do you agree that the power to require the removal of the senior management should be interpreted as relating to those managers directly accountable to the Board?*

We note that the term “senior management” is defined in Article 2(1)(25) to have the same meaning as in Directive 2013/36/EU Article 3(1)(9). This provides the definition “'senior management' means those natural persons who exercise executive functions within an institution and who are responsible, and accountable to the management body, for the day-to-day management of the institution”.

While the requirement to be both “responsible and accountable to the management body” suggests that senior management will have direct accountability to the board, it is ultimately a matter for the European Courts whether persons who report indirectly will always be sufficiently distant from the board to fall outside this definition. We agree, however, that the UK’s current implementation appears to provide for powers to require the removal of both classes of person and therefore it does not seem necessary to take a concluded review.

4. RESOLUTION OBJECTIVES AND THE GENERAL PRINCIPLES OF RESOLUTION

4.1 (6) Do you have any observations on the proposed changes to the special resolution objectives?

We do not think the references to the UK in revised objectives 1, 2 and 3 are consistent with the BRRD, because they appear to require the UK authorities to act only in the interests of the UK. The BRRD at recital 3 notes the integrated nature of the EU’s financial markets and at Article 14 effectively requires resolution authorities to take a broader perspective than that of a single Member

State; Recital 29 emphasises that measures must not be directly or indirectly discriminatory on grounds of nationality. The body of the Directive at Article 34(2) provides resolution authorities must use resolution tools and powers in a way that “minimises the adverse effects on financial stability in the Union and its Member States, in particular, in the countries where the group operates” and Article 87 stresses similar considerations in decision taking by resolution authorities. The BRRD objectives set out in Article 31 and quoted in Table 6A of the Consultation Paper are clearly EU wide. Leaving the objectives in the UK legislation limited to the UK is not consistent with this EU- wide approach and the duties towards other Member States are also not expressed.

In Objective 2, in addition to deleting the reference to the UK we consider it would be better to follow the quoted language from Article 31(2)(2) BRRD rather than retain the words “to protect and enhance the stability of the financial systems of the UK”. The words “protect and enhance” in the current language imply a duty to favour the UK without regard to the position of other Member States, while, once the reference to the UK is removed, the lower obligation “to avoid a significant adverse effect on the financial system” appears more appropriate given that this objective extends to all affected financial systems within the EU.

Objective 3 is not referred to in the BRRD, but is probably not inconsistent if the reference to the UK is deleted. Again, it may be better, given the geographical scope of the objective, to use language such as “preserve” or “avoid a significant adverse effect on” rather than “protect and enhance”.

Finally, we could not see that the principle in Article 34(2) referred to above is reflected in the current legislation (as suggested at para 6.1 of the Consultation Paper) and we think a specific provision dealing with this principle is required. We do not think that the principle in Article 34(3) is specifically covered either – it is intended to be an express acknowledgement that resolution has to be carried out within the State aid framework.

5. CONDITIONS FOR ENTRY INTO RESOLUTION

5.1 (*7) Do you have any comments on the proposed changes to the conditions for entry into resolution?*

We have no comments.

6. VALUATION

6.1 Although the Consultation Paper raises no questions and the work of the EBA will clearly be important in this area, we observe that this valuation exercise will be difficult and complex and that the first valuation will inevitably be provisional. The treatment of contingent claims and damages claims will be particularly important so as to ensure compliance with the duty not to deprive creditors of their rights – which could occur through mis-valuation at this stage.

6.2 As the original UK legislation did not contemplate such a valuation and it is not now intended to implement the recent UK bail-in legislation, we think a specific power for the appropriate UK authority to procure the valuations contemplated by the BRRD may be required to be included in the UK implementation.

7. SPECIAL MANAGER

7.1 (8) *Do you feel that any changes to the Bank's ability to control an institution under resolution would be useful?*

We do not consider that changes are necessary in relation to these powers.

In relation to protecting the authorities and their staff in relation to shadow directors, it would be appropriate to have legislation of general application rather than case by case legislation. Article 72.4 BRRD provides an adequate basis for this. The Dunfermline Order language could be adapted for this purpose.

8. ASSET SEPARATION TOOL

8.1 *(9) Do you agree with the proposal to allow for an "onward asset management vehicle"?*

Yes.

8.2 *(10) Do you agree that it should be possible to use the Bank Administration Procedure with the Asset Management Vehicle, so that the remainder of the bank that is placed in administration can provide services to the Asset Management Vehicle?*

Yes. We observe that there may be occasions where the assets used to provide services to a Bridge Bank and/or an Asset Management Vehicle, might themselves have to be placed in an Asset Management Vehicle (e.g. where the insolvent remainder of the bank is so depleted of assets by the effect of bail-in and Transfer Orders, that it is unable to fund the continued provision of such services at all, but they are vital to recovering value from other assets, or where there is a possibility that the assets used to provide those services will be required by a purchaser of a Bridge Bank and need to be safeguarded for that purpose). Given the provisions of Article 59, it seems unlikely the tool will be available in relation to a bank that, with the removal of such assets, is solvent and has adequate regulatory capital.

8.3 *(11) Do you have any other comments on the suggested approach to transposing the Asset Management Vehicle?*

No.

9. BAIL-IN – EXCLUDED LIABILITIES

9.1 (12) *To the extent that the liabilities in relation to pension benefits attributable to variable remuneration must be within scope of the bail-in powers, do you agree that it should be possible for the pension trustee to reduce his liability to the beneficiary accordingly? Do you have comments on how this could be achieved?*

This question presumably refers to variable remuneration falling within the exception to excluded liability 6. We agree in principle to the extent that the trustee would have a liability in relation to variable remuneration on which no contribution to the scheme had been made. We believe that there will be responses from pension law experts that may be more useful in framing the legislation.

9.2 *(13) Do you agree that liabilities with no fixed maturity and which are callable at any point with less than 7 days' notice should fall within the definition of a liability with an original or remaining maturity of less than 7 days?*

Yes.

9.3 *(14) Do you have any other comments on the proposed changes to s. 48B?*

While we agree that most employers' pension liabilities will be in relation to occupational pension schemes, there will be some individual unfunded pension obligations, particular to individuals in the 80+ age-group, as such pension commitments were more common in 1950s-80s than they have become more recently. In addition, an employer might commit to purchase an annuity or other pension provision on an individual basis in some circumstances. We therefore think that it is important that the excluded liabilities at 7 include also liabilities owed directly to an employee or former employee by way of pension provision.

10. CONTRACTUAL RECOGNITION OF BAIL-IN AND MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES

10.1 (*15) Should the regulators' powers to require the inclusion of a contractual clause regarding recognition of bail-in extend to mixed-activity holding companies where the subsidiary institutions are held by an intermediate financial holding company?*

We do not think these powers should extend to mixed-activity holding companies in those circumstances. If they did so extend, mixed-activity holding companies may have to exclude banking from their activities completely, in order to reduce their cost of capital and remain competitive in other business activities, and this would have adverse effects on competition in the provision of banking services and the efficiency of financial management for such groups.

10.2 (16) *Should the extension of the regulators' powers to require the inclusion of a contractual clause to require mixed-activity holding companies to include contractual recognition provision in accordance with Article 55, and the MREL provisions, be delayed until January 1st 2016?*

We agree with that this requirement should be delayed as proposed. This would enable mixed-activity holding companies to adjust their organisational structures to avoid this requirement.

11. LOSS ABSORBANCY

11.1 *(17) Do you have any comments on the proposed approach to implementing the requirement that shareholders and creditors must make a contribution to loss absorption and recapitalisation equal to at east 8% of the total liabilities of the firm, including own funds, before alternative resolution financing arrangements can be accessed?*

We find the relationship between Article 44 and 45 of BRRD on the one hand, and Articles 59 and 60 on the other, difficult to understand. Articles 59 and 60 appear to provide for a full write down of capital instruments in advance of the use of any resolution tools (see Article 60(5)). This would seem difficult to do without immediate moves into a full scale resolution or government recapitalisation, because the effect of this write-down is likely to be to leave the bank inadequately capitalised. It would seem that Articles 59 and 60 will always govern the write down of capital instruments.

We note that Articles 59 et seq are not part of the resolution tools, but operate independently. It is necessary that the UK legislation recognises this. We comment further on these Articles below.

11.2 *(18) How should situations with a bank or investment firm where over 92% of its liabilities at the point of resolution be dealt with? Do you think that this is a realistic scenario?*

We think this is an unrealistic scenario. If any guidance is thought necessary it should be sought from the EBA, as ultimately it would be a matter for the CJEU to resolve. We think, however, that it is unlikely this issue will arise.

12. SAFEGUARDS FOR PROTECTED ARRANGEMENTS IN BAIL-IN

12.1 *(19) Do you have any comments on the proposed safeguard for protected financial arrangements in bail-in?*

Liabilities for claims for damages could, in some circumstances, be secured (e.g. where a damages claim arises for breach of the terms of a secured debt or where security has been given in respect of a specific claim). Even though these cases will be rare, in order to adhere to the scheme of the BRRD the implementing legislation should provide that the exclusion from the safeguard does not apply to the extent that security has been given in relation to a damages claim.

12.2 Although no comments are sought on the earlier part of section 12 of the Consultation paper, we observe that the safeguards provisions in relation to eligible deposits require further thought in relation to the new Directive 2014/49/EU on deposit guarantee schemes. This effectively makes most personal and corporate bank deposits eligible deposits which are covered for the first euro100,000 or equivalent (currently £85,000). However, eligible deposits are excluded from the safeguards. As most corporate deposits and a few personal deposits are the subject of netting and set-off arrangements, the BRRD requires that they are protected. The Safeguards order should therefore be amended so as to protect these deposits in total if they are transferred under a partial property transfer order, with clarification that transfer of the whole deposit (together with any contracts capable of set off or netting) to an operating bank satisfies the obligation of the FSCS deposit protection scheme to make the covered amount available within a very short space of time. Where an eligible deposit is not to be transferred, then the FSCS will have to pay the depositor the covered amount before or after netting or set off, where this is applicable. The valuation exercise is designed for the prompt identification of net amounts where appropriate.

If eligible deposits subject to netting or set-off are not protected, then this could affect the availability of netting and set off arrangements for corporate deposits, with serious consequences for both banks and their corporate customers, as regards cost of capital for banks and cost of banking for customers.

While it would be possible to provide that the covered amount of the deposits of any depositor with any bank should be excluded from netting arrangements, this would be more difficult to administer (large groups will have a large number of members and several are likely to have more than one account with balances varying greatly according to fluctuations in income and expenditure) so that identification of the excluded amount would be difficult. In addition this would simply reduce the efficacy and ease of administration of the netting and set-off arrangements for both banks and corporate customers. We therefore do not recommend this alternative approach.

13. GOVERNMENT STABILISATION OPTIONS

13.1 Although comments are not sought, we observe that the effect of the requirements of Articles 59 and 60 seems to be that it would be necessary to use one of these options to recapitalise a bank in the short term, if it was desired to continue the same legal entity/ies as a going concern, as (pursuant to Article 60(5)) resolution tools (including these) can only be used when the capital instruments of the bank have been written off, leaving it with an impaired capital structure.

14 WRITE DOWN OF CAPITAL INSTRUMENTS

14.1 *(20) Do you agree with the proposed approach to the implementation of the write down and conversion provisions? Do you have any comments on the draft Order?*

Generally the approach is sensible, but we cannot see any justification in Articles 59 and 60 for the proposed general condition in the new section 6A(2) lead-in that “relevant capital instruments of the bank need to be converted into Common Equity Tier 1 instruments in order to restore the Common Equity Tier 1 ratio of the bank". While this condition would reflect Article 59(3)(b), (c) and (d), the power has to be used also in the circumstances laid down in Article 59(3)(a) and (e), which effectively means before the use of any type of resolution tool or to restore viability. It may be that the new section 6B is intended to cover those other cases, but this is far from clear from the language used and the references back to section 6A which make it appear supplementary to section 6A. We recommend that the drafting is clarified to specifically cover all elements of Article 59(3) in section 6A and deal with mechanics in section 6B.

We also note that while a conversion might restore viability in the broad sense, it would not address either cash flow issues (likely to be exacerbated by the use of this tool) or regulatory capital requirements (which are likely to be depleted below the minimum). Therefore either use of government tools under Articles 56-8, or of the other resolution tools will almost always have to follow.

As the use of this power has to precede resolution and is different from it, it is possible that use of these powers could default the institution’s contracts and not be covered by the statutory provisions intended to prevent use of resolution tools having this effect. To obtain the best possible outcome, we recommend that the protections in Section 48M of the Banking Act 2009 (which currently protect a bail-in from triggering a default event provision) should be extended to a conversion or write off under Article 59 et seq.

This could be remedied in the transposition either by extending the definition of a resolution instrument to include a mandatory writedown or conversion under Article 59 et seq or by inserting a new section replication section 48M specifically for these measures. The legislative basis is provided in that Article 68 of the BRRD requires this protection to be applied to crisis prevention measures which are defined in Article 2(1)(101) to include Article 59 measures. .

14.2 (21) *Do you agree with the Government's preliminary view that the "No shareholder or creditor worse off" safeguard does not apply in relation to the write-down and or conversion of capital instruments?*

We note that Article 60(2)(b) provides that "no liability to the holder of the relevant capital instrument shall remain under or in connection with that amount of the instrument, which has been written down, except for any liability already accrued, and any liability for damages that may arise as a result of an appeal challenging the legality of the exercise of the write-down power;"

This appears to preclude application of the "no shareholder worse off" provision, but it is necessary to provide a mechanism for the holders of relevant capital instruments to assert that the power has been incorrectly exercised. In view of the reference to damages, consideration needs to be given to whether there is clearly a right to bring a claim for damages under general law, bearing in mind that this remedy is not one that flows from judicial review.

15. POWERS OVER BRANCHES OF THIRD COUNTRY INSTITUTIONS

15.1 *(22) Do you agree with the proposal not to extend share transfer powers to branches of third country institutions?*

Yes. This power would be extremely difficult to exercise under the present legal framework for dealing with the insolvency of a foreign company, where UK processes are likely to be ancillary.

15.2 *(23) Do you feel that the Bank of England should have the full set of resolution powers (with the exception of share transfer powers) over branches of third country institutions when acting independently to resolve a branch?*

Yes – building on UK insolvency law, these would be powers in relation to the company with a branch in the UK, limited in application to measures necessary to resolve the branch.

15.3 *(24) If not, what powers do you feel would be appropriate, in order to ensure that the risks posed by branches of third country institutions can be addressed effectively?*

Not applicable.

15.4 *(25) How should the assets, rights and liabilities of the branch be defined for the purposes of resolution of a branch?*

This is a difficult question, especially as banking is a highly international activity. Our comment on the insolvency law approach may be useful as powers can be given without definition of these assets, rights and liabilities. A regulated branch may be required to produce regulatory accounts which would be a basis for identifying those assets for the purposes of use of these powers.

16. RESOLUTION FINANCING ARRANGEMENTS

16.1 *(26) Should the bank levy be used to meet the ex-post funding requirements and replace the initial contributions from the bank levy in the event they are used, or should these be repaid by establishing resolution financing arrangements which follow the Delegated Act on contributions to resolution financing arrangements?*

This is primarily a matter on which the views of banks paying the levy are relevant. Option 1 is closer to the present arrangements and may therefore be easier to implement, at least in the short term.

16.2 *(27) Should the contribution of the deposit guarantee scheme be capped at 50% of the target level of the deposit guarantee scheme, or at a higher level?*

This is a financial matter on which we have no views.

17. DEPOSITOR PREFERENCE

17.1 *(28) Do you agree that floating charges should rank after secondary preferential debts on insolvency? If not, what characteristics do floating charges have which make them suitable to benefit from higher protection?*

We do not think this is the right approach for floating charges created by banks. For regulatory reasons a bank is not likely to create a “qualifying floating charge” over substantially all its assets. That is the only sort of floating charge which might be suitable for ranking after deposits as proposed, a ranking which is highly likely to destroy all value in the charge.

The only floating charges created by banks are over discrete pools of assets – eg securities – often to provide collateral to exchanges or central counterparties. Where the security arrangements allow the bank to manage substitution of the securities in the pool, provided that value is maintained and there is no default, English law is likely to characterise the charge as “floating” even though the parties have expressed their charge to be fixed: it is extremely difficult to be certain that in law a fixed charge has been created with such a degree of possession and control for the charge-holder that the English courts will recognise it as fixed, yet it is hugely inefficient to restrict management of the charged portfolio. If this type of charge were rendered effectively valueless by postponement to depositors then all UK banks and branches of foreign banks liable to resolution in the UK, will be at a considerable and unnecessary disadvantage in the financial markets, and financial markets whose local legal systems do not raise this problem will be at an advantage to the City. The lack of effective priority for these charges could also add to the risks to financial stability occasioned by the failure of a bank.

Given the importance of these charges (the characterisation of which is uncertain) to the financing and business operations of banks, we recommend strongly that floating charges are not postponed to deposits, or at least that postponement is limited to qualifying floating charges as defined in the Insolvency Act 1986 (as amended in the Enterprise Act 2002). We also note that this issue emphasises the need to tackle the underlying legal problem, which has been too long postponed.

Even if not postponed to depositors, the present position is that very many types of floating charges (including market and system charges which are recognised as important to the operation of the financial system and other charges over discrete but variable pools of assets as described above) will not fall outside the definition of of a security financial collateral arrangement as defined in the Financial Collateral Arrangements Regulations ("FCARs") as a result of recent case law. This means that Article 10(2A) of the FCARs, which gives priority over preferential creditors, will not apply and in addition the charged assets under UK insolvency law are under the control of the administrator and not available to the charge-holder, as envisaged by the Directive underlying the Regulations.

Charges given to CREST settlement banks by CREST members over their securities in CREST are a prime example of system charges which are floating charges. While, despite being floating charges they may benefit from Article 14(6) of the SFRs, because Euroclear UK and Ireland Limited (the operator of CREST) is designated under the SFRs and these charges should qualify as "collateral security" for the purposes of the SFRs. This will apply to give these charges priority over preferential debts, provided that these new preferential debts are clearly included - which may require amendment to this provision. However, not all systemically important counterparties are designated under the SFRs and, as explained above, Article 10(2A) of the FCARs will apply to floating charges only in rare instances.

However there are other floating charges or deemed floating charges which are system or market charges which will fall through the gaps of designation and without other amendments to the FCARs will be postponed to deposits and therefore unable to provide collateral to support the smooth working of the financial system. There are powers in the Banking Act 2009, as amended, which should be used to ensure that those floating charges vital to the operation of the financial system (which will include those created by banks) can benefit from the Regulations and effectively be treated in the same way as fixed charges with priority to preferential debts. Again Article 10(2A) FCARs may require amendment to include these new categories of preferential debt.

17.2 *(29) Are you aware of any pre-1997 corporate shareholding members of a building society?*

We believe the Building Societies Association would have the best and most complete information on this.

17.3 *(30) Should the powers under section 90B of the Building Societies Act 1986 be exercised so that any existing accounts which will not benefit from depositor preference rank pari-passu with unsecured creditors?*

The discussion in section 17 of the Consultation paper suggests that deposits not qualifying for depositor preference would rank pari-passu with unsecured creditors. We note that most accounts with building society will qualify fully for either primary or secondary depositor preference.

Assuming that there are old corporate deposits that do not qualify for coverage by FSCS after the scheme is extended to corporate deposits in July 2015, we agree it would be appropriate that these rank pari-passu with unsecured creditors.

OTHER – CLARITY OF LEGISLATION

We draw the attention of the Government to the opening recital of Directive 2014/49/EU (on deposit guarantee schemes) which reads as follows: "Directive 94/19/EC of the European Parliament and of the Council has been substantially amended. Since further amendments are to be made, that Directive should be recast in the interests of clarity."

For a British lawyer, Directive 94/19/EC as amended was not particularly tortuous. By comparison, UK law in the fields of Financial Services and banking regulation, both primary and secondary, is extensive and complex and is a minefield of much amended provisions (such that the numerical conventions of section and article numbering are sadly strained). In addition no official consolidated texts are published in a timely fashion for primary legislation and none at all for secondary legislation. Yet this legislation applies in areas of huge importance to the UK economy and its international standing and the legislation is the focus of efforts at better enforcement.

Can we urge the Government, once the current round of legislation is complete, to address as a priority the production of consolidated legislation in the fields of financial services and bank regulation, or, at least, the prioritisation of production of official consolidated texts for the statutes and key SIs. This would represent a considerable saving of money for all concerned in dealing with this legislation, including Government and enforcement authorities and should enhance understanding and enforcement potential for this legislation, as well as providing very much greater clarity for the international audience affected by it.

This submission was prepared by a joint working party made up as follows:

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